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No. 85-554

IN THE
Supreme Court of the United States
OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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BRIEF *AMICUS CURIAE* OF NEW YORK LIFE INSURANCE COMPANY

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BRIEF *AMICUS CURIAE* OF NEW YORK LIFE INSURANCE COMPANY

This brief in support of respondent is submitted with the written consent of counsel for respondent and the Solicitor General filed with the Clerk of the Court.

INTEREST OF THE *AMICUS CURIAE*

New York Life Insurance Company (the "Company") is a mutual life insurance company required by section 811 of the Internal Revenue Code to utilize the accrual method of accounting for federal tax purposes. While subject to taxation under Subchapter L of the Internal Revenue Code, which applies specifically to life insur-

ance companies, the Company is nevertheless subject to the generally applicable all events test of tax accounting.

The all events test governs the accrual of deductions for tax purposes and is a pervasive principle of tax accounting. The Company applies the test to a broad range of deductions in the determination of its federal income tax liability. In so doing, the Company abides by an interpretation of the test that has long been established by a substantial body of precedent. While the court below has correctly applied the test to the facts of this case, the government contends otherwise and advances a position that sharply departs from the longstanding precedent. Indeed, the broad arguments put forward by the government do violence to the most fundamental precepts of the all events test and would greatly restrict the types of liabilities accruable under that test. Given its substantial utilization of the all events test, the Company faces the threat of significantly increased tax liability if the arguments advanced by the government were to prevail.

The Company is particularly concerned because those arguments go far beyond what is necessary for the Court to resolve this case consistently with the accepted understanding of the all events test. It is hoped that this brief *amicus curiae* will be of assistance to the Court in its evaluation of the government's wide-ranging contentions.

SUMMARY OF ARGUMENT

Proper application of the all events test focuses on whether the taxpayer is subject to an existing liability at year end. In making this determination, it is irrelevant whether such liability is enforceable at year end and, accordingly, whether any person is identified at year end who could at that time assert a claim based upon the liability. The government's contention to the contrary is based upon a misperception of the analysis required under the all events test, and injects into this case a false

issue that is wholly extraneous to the proper resolution of the case.

In applying the all events test, the crucial distinction is whether at year end the taxpayer is subject to an existing liability, which can be created by statutory, regulatory, or contractual obligations imposed on the taxpayer, or whether the taxpayer's liability does not yet exist but is contingent upon the occurrence of future events. In the latter instance, the future events are "conditions precedent" which must occur before a taxpayer's liability can satisfy the all events test. Other future events, which may act to terminate a taxpayer's existing liability, are "conditions subsequent" and do not prevent the accrual of such existing liability. Still other future events have no impact on the existence of liability, but only affect the timing or manner in which that liability is paid or satisfied, or the identity of the ultimate payee, and thus do not affect the analysis of whether a taxpayer's liability satisfies the all events test. These analytical principles are firmly established by the overwhelming weight of precedent. The government's position simply ignores this precedent and thus the rule of stare decisis.

The court below correctly determined that the applicable Nevada Gaming Commission regulation subjected respondent to an existing liability to pay out its year-end guaranteed jackpots, and that any uncertainties surrounding the ultimate timing or receipt of payment of that existing liability were either conditions subsequent or other future events that did not prevent the liability from satisfying the all events test. In reaching a contrary result, the Ninth Circuit in *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982), upon which the government places principal reliance, inexplicably failed to consider whether the state regulation created an existing year-end liability. As a result of that failure, the Ninth Circuit was forced to view the winning slot ma-

chine handle pull as a condition precedent to the creation of the taxpayer's liability. Based solely upon this erroneous premise, the Ninth Circuit found that uncertainties surrounding the occurrence of the perceived condition precedent prevented accrual under the all events test.

The decision in *Nightingale* is contrary to established precedent, both generally and in the Ninth Circuit, and should be rejected in favor of the reasoning of the decision below. However, if this Court disagrees, its basis for decision should be limited to the ground that the specific state regulation at issue fails to create an existing year-end liability. Moreover, this Court should limit any holding ascribing relevance to uncertainties surrounding the ultimate timing or receipt of payment to situations in which the underlying liability is subject to a condition precedent and therefore does not exist at year end.

Accrual of respondent's year-end liability for guaranteed jackpots (as opposed to estimates of future jackpots ultimately paid) accurately matches income to expenses and therefore clearly reflects its income. The cases cited by the government in support of its position that the Commissioner has broad powers to determine whether a method of accounting clearly reflects income are not on point because they all involve taxpayers that have attempted to avoid the application of accepted tax accounting principles through the use of estimates of future liability. The opportunities for tax avoidance that the government speculates would be created if the decision below is affirmed simply do not exist, especially since Congress has recently enacted new rules that apply to restrict the accrual of liability under the all events test.

ARGUMENT

I. THE GOVERNMENT'S ARGUMENT MISPERCEIVES THE PROPER FOCUS OF ANALYSIS UNDER THE ALL EVENTS TEST

The all events test was formulated by this Court in *United States v. Anderson*, 269 U.S. 422 (1926). The test is met when all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy. In *Anderson* and subsequent cases, the focus of analysis under the all events test has been on whether at year end the taxpayer is subject to an existing liability. In applying the all events test, the courts have not required that an existing liability of the taxpayer be enforceable at year end by any third party. For example, in *Anderson* itself, a tax liability was held to be accrued in 1916 even though it was not assessed and due until 1917. For an expense to accrue in a taxable year under the all events test, it is only necessary that "a valid obligation to pay must have existed in that year, which is enforceable on the date when the obligation is due." *Helvering v. Russian Finance & Construction Corp.*, 77 F.2d 324, 327 (2d Cir. 1935). A liability accrues under the all events test if at year end it "is so fixed that the fact of liability is certain and the amount thereof reasonably ascertainable, although not necessarily legally enforceable." *Eastman Kodak Co. v. United States*, 534 F.2d 252, 257 (Ct. Cl. 1976).

The government here erroneously ignores the existence of the taxpayer's liability. Instead, the government claims that it is necessary to identify at year end some person who could attempt to enforce the taxpayer's existing liability. By focusing upon the ultimate recipient of payment of the taxpayer's existing liability, the government forsakes established principles of analysis under the all events test and creates a straw man which

draws attention away from the proper inquiry: whether the taxpayer's liability exists at year end.[1]

Viewed in this proper perspective, the decision of the court below fits squarely into the framework of the all events test as established by a substantial body of precedent. Analysis of this precedent demonstrates that respondent's year-end liability to pay guaranteed jackpots satisfies the all events test and that the uncertainties perceived by the government with regard to the ultimate timing, receipt and amount of payment of that liability are irrelevant.

II. THE PARAMETERS OF THE ALL EVENTS TEST HAVE BEEN FIRMLY ESTABLISHED

In applying the all events test, the crucial distinction is whether at year end the taxpayer is subject to an existing liability, or whether the taxpayer's liability does not yet exist but is contingent upon the occurrence of future events. In the latter instance, the future events are "conditions precedent" which must occur before the taxpayer's liability can be accrued. Other future events, which may act to terminate an existing liability, are "conditions subsequent" and do not prevent accrual. Still other future events have no impact on the existence of liability, but only affect the timing or manner in which that liability is ultimately paid or satisfied, or the identity of the ultimate payee, and thus have no impact on accruability.

While the government's argument relies upon cursory analysis and attempts to blur these clear distinctions, the following discussion demonstrates that the distinctions are uniformly recognized in the application of the all

[1] The government creates a straw man in the sense that its position would presumably be the same even if the progressive slot machines involved could be played by only one person so that the identity of the eventual winner of the guaranteed jackpots was established at year end.

events test. Under the government's position, these established all events test principles would simply be ignored and the rule of stare decisis would be violated.

A. Conditions Precedent to the Existence of Liability Prevent Accrual Under the All Events Test

It is well settled that the all events test is not met when the very existence of liability is contingent upon the occurrence of a condition precedent.

Many of the cases relied upon by the government to support its position in this proceeding involve conditions precedent. For example, in *Brown v. Helvering*, 291 U.S. 193, 200 (1934), this Court held that a general insurance agent could not deduct a claimed liability for refunds of commissions that would be due if policies sold by the agent were cancelled in a subsequent year, "since the events [the cancellations] necessary to *create* the liability do not occur during the taxable year" (emphasis added). Similarly, in *Trinity Construction Co. v. United States*, 424 F.2d 302, 305 (5th Cir. 1970), the court held that an employer could not deduct a claimed liability for subsequent years' annual premiums on employee life insurance, since the employer's liability for those premiums did not exist prior to the due dates of the remaining premiums. On similar reasoning, in *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450, 453 (8th Cir. 1983), the court held that an employer could not deduct a claimed liability for contributions to a profit-sharing plan, since the employer's liability did not exist prior to the due dates of the contributions. Finally, in *World Airways, Inc. v. Commissioner*, 62 T.C. 786, 803 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977), the Tax Court stated that the taxpayer could not deduct a claimed liability for overhaul expenses since, until the equipment involved had been operated for "the applicable number of flight-hours, no obligation to overhaul arises."

In each of these cases, the future contingent events were conditions precedent that created, or "fixed," the taxpayers' liability. Thus, in these cases, the taxpayer's liability did not exist at year end, but arose only upon the occurrence of the future event constituting the condition precedent.

B. If the Existence of Liability Is Subject to a Condition Precedent, It Is Irrelevant Whether the Condition Precedent Is Likely to Occur

As a corollary to the principle that contingent liabilities which arise only upon the occurrence of conditions precedent do not satisfy the all events test, it is well settled that the fact that a condition precedent is likely to occur will not serve to establish the liability.

Many cases relied upon by the government involve instances in which taxpayers have argued that the all events test is satisfied because liability is likely to arise. For example, in *Brown v. Helvering*, 291 U.S. at 201, this Court rejected the taxpayer's contention that liability contingent upon the cancellation of insurance policies was established by the fact that "there is a strong probability that many of the policies written during the taxable year will be so cancelled." Similarly, in *Bennett Paper Corp. v. Commissioner*, 699 F.2d at 453, the court refused to allow accrual of a claimed liability despite its recognition of the fact that the condition precedent was likely to occur.

In these and other cases the courts have rejected claims that deductions are accruable based "upon a prediction that liability ultimately might be established." *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1307 (9th Cir. 1983). *Accord Milwaukee & Suburban Transport Corp. v. Commissioner*, 18 Tax Ct. Mem. Dec. (CCH) 1039 (1959), *rev'd*, 283 F.2d 279 (7th Cir. 1960), *vacated and remanded*, 367 U.S. 906 (1961), *aff'd on remand*, 293 F.2d 628 (7th Cir. 1961); *Supermarkets General Corp. v. United States*, 537 F. Supp. 759 (D.N.J. 1982).

C. Liability Can Be Created by Statutory and Contractual Obligations

If liability is not subject to a condition precedent, but currently exists, then that liability generally satisfies the all events test. *E.g., American National Co. v. United States*, 274 U.S. 99 (1927).[2] For this purpose, the liability may be created or "fixed" by a statutory, regulatory, or contractual obligation imposed on the taxpayer. This principle is of critical importance in this case.

In its argument, the government largely ignores the fact that this principle exists and is supported by a substantial body of precedent. For example, in *United States v. Anderson*, 269 U.S. 422 (1926), this Court held that a federal tax statute imposed a fixed liability in 1916 even though the tax was not assessed and was not due until 1917. In *Anderson*, this Court held that the *statute* fixed the liability and refused to consider the *assessment* of the tax to be a necessary event.[3] In *Helvering v. Russian Finance & Construction Corp.*, 77 F.2d 324 (2d Cir. 1935), a taxpayer receiving deliveries of mineral ore was obligated by contract to make future payments of a mineral royalty. The court allowed the taxpayer to accrue the liability, stating that: "The liability to pay [a royalty of] $2 by this taxpayer arose

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[2] However, the all events test is not satisfied if the taxpayer contests that liability. *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944). Congress has specifically addressed the issue of contested liabilities in section 461(f) of the Internal Revenue Code.

[3] The Nevada Gaming Commission regulation and the winning handle pull in this case are directly analogous to the tax statute and the assessment of the tax in *Anderson*.

upon the delivery of the ore, and, in every sense, was properly an accruable item of expense. It was absolute and fixed, in that no further event needed to occur to bring it into existence" (*id.* at 327). Similarly, in *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d 607 (2d Cir. 1942), the court allowed an employer to accrue a liability to pay employee bonuses which was imposed on the employer by an implied contract with its employees and fixed in amount by a board of directors' resolution. In *Champion Spark Plug Co. v. Commissioner*, 30 T.C. 295, 298 (1958), *aff'd*, 266 F.2d 347 (6th Cir. 1959), the Tax Court allowed accrual of a liability established by an "unconditional obligation" created by a board of directors' resolution. Moreover, in *Washington Post Co. v. United States*, 405 F.2d 1279, 1281 (Ct. Cl. 1969), the court allowed a taxpayer to accrue a liability to make contributions to a dealers' profit incentive plan, which had been adopted "without signing any formal contract with individual dealers or with the dealers in aggregate." The court held that the taxpayer was "irrevocably bound [under the terms of the plan] to pay whatever it accrues to the [plan's] Fund" (*id.* at 1283).

The principle that a liability may be created by a statutory, regulatory, or contractual obligation has been recently reaffirmed in the context of workmen's compensation statutes. In *Crescent Wharf & Warehouse Co. v. Commissioner*, 59 T.C. 751 (1973), *rev'd*, 518 F.2d 772 (9th Cir. 1975), the court of appeals held that upon the occurrence of an injury to a worker in the course of employment, the California workmen's compensation law imposes an obligation on the employer and creates an existing liability that satisfies the all events test. *Accord Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983). In *Wien Consolidated Airlines, Inc. v. Commissioner*, 60 T.C. 13 (1973), *aff'd*, 528 F.2d 735 (9th Cir. 1976), it was similarly concluded that upon the

death of an employee, an existing liability is created by the Alaska workmen's compensation law.[4]

The principle has also been established in a series of cases involving supplemental unemployment benefit ("SUB") plans established pursuant to collective bargaining agreements. For example, in *Lukens Steel Co. v. Commissioner*, 52 T.C. 764 (1969), *aff'd*, 442 F.2d 1131 (3d Cir. 1971), the court held that a SUB plan imposed an obligation which created an existing liability to pay future benefits that satisfies the all events test. *Accord, e.g., Crucible Inc. v. United States*, 591 F.2d 643 (Ct. Cl. 1979); *Inland Steel Co. v. United States*, 212 Ct. Cl. 558 (1976); *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943 (1977).

Finally, the principle has been established in a line of cases involving strip mining reclamation statutes. In *Harrold v. Commissioner*, 192 F.2d 1002, 1003 (4th Cir. 1951), the court held that "the contractual and statutory obligation" imposed on the taxpayer to restore and refill land mined during the year created an existing liability that satisfied the all events test. *Accord Denise Coal Co. v. Commissioner*, 271 F.2d 930, 935 (3d Cir. 1959) (the reclamation statute "imposes a fixed and definite obligation"); *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir.), *cert. denied*, 348 U.S. 828 (1954); *Patsch v. Commissioner*, 208 F.2d 532 (3d Cir. 1953); *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981).

These cases clearly establish that statutory, regulatory, or contractually imposed obligations create year-end liability that is sufficiently certain to satisfy the all events test.

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[4] In *ESCO Corp. v. United States*, 750 F.2d 1466 (9th Cir. 1985), the government did not even argue that the Oregon workmen's compensation statute failed to fix the taxpayer's liability, contending only that the amount of the taxpayer's liability could not be determined with reasonable accuracy.

D. Conditions Subsequent That May Terminate Existing Liability Do Not Prevent Accrual Under the All Events Test

As a corollary to the principle that statutory, regulatory, or contractual obligations can create existing liability sufficient to satisfy the all events test, it is well settled that the existence of "conditions subsequent" that may diminish or terminate an existing liability do not prevent accrual of such a liability under the all events test.

In its brief, the government also ignores the fact that this principle exists and is supported by substantial precedent.[5] For example, in *Helvering v. Russian Finance & Construction Corp.*, the court noted that the contracts provided for contingencies the occurrence of which would terminate the taxpayer's liability to pay royalties, but held that: "The possibility that a present liability may subsequently be discharged by some condition subsequent does not prevent its accrual . . . . A presently existing obligation, which the taxpayer has reasonable grounds to believe must eventually be fulfilled, is not uncertain or contingent in the sense that it may not be accrued" (77 F.2d at 327). *Accord W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974). On similar reasoning, in *Lutz v. Commissioner*, 396 F.2d 412, 414 (9th Cir. 1968), the court held that the fact that a third party was challenging the tax statute under which the taxpayer's liability was imposed, "is too remotely connected with the taxpayer to [cause the court to] describe the [taxpayer's] liability as contingent." In

[5] However, in its Reply Memorandum to respondent's Brief in Opposition (at 3), the government acknowledged that: "Remote contingencies like bankruptcy, which might serve to divest respondent of its obligation on liabilities once they have become fixed, are properly regarded as 'conditions subsequent.' It is well settled that conditions of the latter sort do not preclude accruals under the 'all events' test, and we are not contending otherwise."

Lawyers' Title Guaranty Fund v. United States, 508 F.2d 1, 4 (5th Cir. 1975), the court distinguished "between an imperfect right subject to later perfection, a condition precedent, and a vested right subject to divestment," and held that the all events test is not regarded as "failed merely because a 'condition subsequent' may interfere with actual payment" (*id.* at 6). This distinction was also recognized in *Zwicker Knitting Mills v. United States*, 47 A.F.T.R.2d (P-H) ¶ 81,310, at 81-335 (Ct. Cl. 1980), in which the court held that: "once a liability is properly accrued, the possibility of a subsequent, unexpected event changing its absolute character or discharging payment entirely should not alter its treatment as a fixed liability during the years accrued." *Accord Wien Consolidated Airlines, Inc. v. Commissioner*, 60 T.C. at 15.

Thus, courts have recognized that conditions subsequent do not prevent existing liabilities from satisfying the all events test.

E. Other Events Have No Effect on the Accrual of Liability Under the All Events Test

Other future events may occur that constitute neither conditions precedent nor conditions subsequent. These future events have no effect upon the existence of the liability, but merely upon the timing or manner in which the liability is ultimately paid or satisfied, or the identity of the ultimate payee. Since these events do not affect the existence of liability, they have no effect upon the determination of whether liability accrues under the all events test.

The government relies heavily on these types of future events, failing to note that courts have recognized that year-end uncertainty over the ultimate timing, receipt and amount of payment does not alter the fact that an existing liability is fixed and, thus, does not prevent satisfaction of the all events test. For example, in *Washing-*

ton Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969), the court considered the government's contention that the taxpayer's liability was not fixed for purposes of the all events test because the group of potential recipients "is capable of constant change, and neither the ultimate recipients of the Fund, nor the time of distribution can be ascertained in the year of accrual" (405 F.2d at 1283). The court rejected the government's contention, pointing to "the one overriding reality in this case: plaintiff is irrevocably bound to pay whatever it accrues to the Fund" (*id.*). The court held that "the indeterminancy involved does not make the liability any less real, or any less fixed" (*id.*). *Accord General Dynamics Corp. v. United States*, 6 Cl. Ct. 250 (1984), *aff'd*, 773 F.2d 1224 (Fed. Cir. 1985).

Uncertainty with regard to the ultimate timing, receipt and amount of payment also has been held not to prevent accrual in *Lukens Steel Co. v. Commissioner*, and in the other cases involving liabilities under SUB plans. For example, in *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943, 960 (1977), the court held that "[t]he crucial point is the legal liability to pay someone at some point in time." Similarly, the cases involving reclamation statutes have not required such year-end certainty. In *Ohio River Collieries Co. v. Commissioner*, the court stated that "[t]he fact that the recipients of petitioner's reclamation payments and the relative portions that they would receive were not identified in the tax year is irrelevant" (77 T.C. at 1375). In *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d at 609, the court held the fact that during the year of accrual an employee of the taxpayer could not ascertain his proportionate share of the accrual was not "relevant to the issue of deductibility." Finally, in *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 406 (5th Cir. 1969), the court held that uncertainty over when payment of the liability would occur does not prevent a liability from satisfying the all events test.

Other events which are related solely to the manner in which existing liability is paid or satisfied similarly have no affect on accruability. For example, in *Ohio River Collieries Co. v. Commissioner*, the court explained that there were alternative methods by which the taxpayer's existing liability to reclaim might be satisfied; by performance of the reclamation or by forfeiture of the surety bond that the taxpayer had posted with the state. (77 T.C. at 1375.) The existence of this uncertainty did not prevent accrual of the taxpayer's underlying liability to reclaim. *Accord Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959).

III. THE COURTS BELOW CORRECTLY APPLIED THE ALL EVENTS TEST

The courts below correctly applied the all events test to the facts presented and decided the case consistently with the precedent discussed above.

The courts below held that the Nevada Gaming Commission regulation subjected respondent to an obligation sufficient to create an existing year-end liability. The Claims Court thoroughly analyzed the Nevada Gaming Commission regulation and found that under that regulation, "once accumulated, a 'guaranteed' jackpot cannot be lessened or eliminated except by a payoff" (5 Cl. Ct. at 643). The Claims Court held that the regulation created an existing liability (*id.* at 645):

> At the end of plaintiff's fiscal year, plaintiff's obligation to pay out the recorded amount is "unconditionally fixed" by the terms of § 5.110. Under that regulation, the liability for the jackpot amount can be enforced by the Nevada Gaming Commission.

The court of appeals agreed, stating that "[t]he commission regulation makes the guaranteed jackpot a fixed liability" (760 F.2d at 1293). Thus, consistent with the substantial body of precedent discussed above, the courts below held that the applicable state regulation imposed an obligation to pay out the jackpot guaranteed at year end and, therefore, an existing liability.

Moreover, the courts below correctly held that any year-end uncertainty regarding the ultimate timing, receipt and amount of payment does not affect the existing liability created by the state regulation. The Claims Court reasoned that (5 Cl. Ct. at 645):

> The winning handle pull . . . only determines the "fortunate gambler" in whose favor the liability is enforced. That the identity of that "fortunate gambler" is unknown, that the exact time the jackpot will be won is unknown, or that the exact amount of the jackpot at the time it is won is unknown does not affect the certainty of the liability at the end of plaintiff's fiscal year; in other words, "when the liability itself is clearly fixed . . . other uncertainties do not necessarily destroy that initial certainty." Washington Post Co. v. United States, 186 Ct. Cl. 528, 536 (1969).

The court of appeals agreed, holding that: "This liability [created by the regulation] is not contingent upon the time of payment or the identity of the jackpot winner" (760 F.2d at 1293). Thus, the courts below held, consistent with established precedent, that any uncertainties that exist at year end regarding the ultimate timing, receipt and amount of payment of the liability are irrelevant to the issue of whether the liability satisfies the all events test.

In sum, the decisions below are consistent with the established precedent concerning application of the all events test.

IV. THE NINTH CIRCUIT DECISION UPON WHICH THE GOVERNMENT PRINCIPALLY RELIES WAS WRONGLY DECIDED

In *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982), the only authority that directly supports the government's position here, the Ninth Circuit incorrectly applied the all events test in a manner that is inconsistent with the established precedent.

While the court in *Nightingale* noted the existence of the Nevada Gaming Commission regulation (684 F.2d at 612-13), that court inexplicably failed to recognize the significance of the regulation and completely ignored it in its analysis of whether the taxpayer's year-end liability satisfied the all events test. Instead, the court held that "the winning of the progressive jackpot by some fortunate gambler" (*id.* at 614) should be regarded "as a condition precedent and not as a condition subsequent" (*id.* at 615) to the taxpayer's liability and, accordingly, that: "Until that event occurs, no actual liability has been incurred" (*id.* at 614).

In reaching this conclusion, the *Nightingale* court simply failed to consider the issue whether the Nevada Gaming Commission regulation imposed an obligation on the taxpayer sufficient to create a year-end liability to pay guaranteed jackpots. Having failed to recognize that the taxpayer's liability was in fact established at year end by state regulation, the court, saddled by this erroneous perception, proceeded to apply the principle that a liability which arises only upon the occurrence of a condition precedent (believed by the court to be the winning handle pull) is not fixed for purposes of the all events test even though the condition precedent is likely to occur (based upon gambling probabilities). Relying upon *Brown v. Helvering* and *World Airways, Inc. v. Commissioner*, the court concluded that "the fact of liability was too contingent to permit accrual" (684 F.2d at 615).

The *Nightingale* court erred in failing to consider the effect of the Nevada Gaming Commission regulation. The court's analysis, which is wholly premised on its failure to consider the state regulation, may be correct insofar as it stands for the proposition that gambling probabilities which make it likely that *nonguaranteed* jackpots will be paid are insufficient to permit accrual

under the all events test. However, the court's analysis ignored the controlling fact: that the casino's liability to pay *guaranteed* jackpots is accruable, not based upon the likelihood that liability will arise when such a jackpot is won, but based upon the existing liability created by the regulatory obligation imposed on the casino to keep the guaranteed jackpot available and to pay out the jackpot when it is won.

Finally, the court in *Nightingale* stated that: "No one can say who will hit the jackpot on that machine, how much it will be when he hits it, or when he will hit it. There are just too many contingencies to permit accrual of the liability as the taxpayers would have us do" (*id.* at 614). In addressing these uncertainties regarding the ultimate timing and receipt of payment, the court premised its analysis on its erroneous belief that the winning handle pull should be regarded "as a condition precedent and not as a condition subsequent" to the existence of the taxpayer's liability (*id.* at 615). Therefore, in emphasizing the significance of these uncertainties, the court was addressing the narrow issue of whether gambling probabilities alone are sufficient to permit accrual of a liability that does not yet exist but which is likely to arise. Since the court failed to consider the question whether the Nevada Gaming Commission regulation established an existing year-end liability, the court did not address the issue whether the uncertainties involved, either as conditions subsequent to that liability or as other future events, could operate to prevent accrual of an existing liability. In other words, because the court did not address the issue whether the Nevada Gaming Commission regulation created a liability which existed at year end, the court never considered whether these types of "uncertainties . . . destroy that initial certainty." *Washington Post Co. v. United States*, 405 F.2d at 1284.

The Ninth Circuit's decision in *Nightingale* is particularly puzzling, since that court has emphatically recog-

nized, both before and after *Nightingale*, that statutory obligations can create liability and that such liability is accruable under the all events test, despite the existence of uncertainties such as those present in *Nightingale*. As previously mentioned, in *Crescent Wharf & Warehouse*, *Wien Consolidated Airlines* and *Kaiser Steel*—all Ninth Circuit cases—the court has held that workmen's compensation statutes act to create liability with sufficient initial certainty to satisfy the all events test. Moreover, in each of those cases, the Ninth Circuit has rejected the government's arguments that various uncertainties regarding ultimate payment are sufficient to destroy that initial certainty. *E.g.*, *Kaiser Steel Corp.*, 717 F.2d at 1306 n.3. On the other hand, in *World Airways*, the Ninth Circuit has recognized that liabilities which come into existence only upon the occurrence of a condition precedent do not satisfy the all events test. In that case, the court rejected the taxpayer's argument that it was subject to a year-end liability created by contractual and statutory obligations, holding that no contractual or statutory obligation existed at year end. *World Airways* is distinguishable from this case, since the Nevada Gaming Commission regulation did impose a year-end obligation.

In *Nightingale*, the Ninth Circuit analogized to *World Airways*, failing to cite or distinguish its own workmen's compensation decisions. This indicates that the Ninth Circuit failed even to consider the possibility that the Nevada Gaming Commission regulation might create an existing liability. This analysis is confirmed by *Kaiser Steel Corp.*, in which the Ninth Circuit distinguished its workmen's compensation decisions from *World Airways* and likened *Nightingale* to *World Airways*, stating that (717 F.2d at 1308 n.6):

> [In *World Airways*] the taxpayer was under no contractual obligation to make any payments unless the engines were actually overhauled. 62 T.C. at 802.

Thus, no obligation to pay ever came into existence. *Id.* at 804. *See Nightingale v. United States*, 684 F.2d 611, 615 (9th Cir. 1982).

The only way to reconcile these cases is to assume that in *Nightingale* the Ninth Circuit completely ignored the operation of the Nevada Gaming Commission regulation.

V. THE ISSUE PRESENTED SHOULD BE RESOLVED ENTIRELY ON THE BASIS OF THE PROPER INTERPRETATION OF THE NEVADA GAMING COMMISSION REGULATIONS

As described above, consistent with established precedent, the court below held that respondent's year-end liability to pay out its guaranteed jackpots is established by the Nevada Gaming Commission regulation, and that any uncertainties that exist regarding the ultimate timing, receipt and amount of payment of that liability do not prevent accrual of the existing liability under the all events test. Respondent properly urges this Court to affirm the decision of the court below on the ground that the Nevada Gaming Commission regulation establishes an existing year-end liability. The court below correctly held that "[t]he commission regulation makes the guaranteed jackpot a fixed liability" (760 F.2d at 1293).

However, if this Court disagrees, its basis for decision should be limited to the ground that the specific Nevada Gaming Commission regulation at issue fails to create a year-end liability to pay out guaranteed jackpots. This Court should not disturb or restrict the general principle that various statutory, regulatory, and contractual obligations imposed on taxpayers create liability with sufficient initial certainty to satisfy the all events test. Indeed, to reject that general principle the Court would be required to overturn a substantial body of precedent.

Respondent also properly urges this Court to affirm the decision of the court below on the ground that any

year-end uncertainties regarding the ultimate timing, receipt and amount of payment do not affect the initial certainty of respondent's liability as created by the state regulation for purposes of the all events test. The court below correctly held that these uncertainties have no effect on respondent's existing liability and do not prevent satisfaction of the all events test.

However, if this Court disagrees that respondent's liability is established at year-end by state regulation, and considers a winning handle pull to be a condition precedent, then it should limit its decision regarding the uncertainties surrounding the ultimate timing, receipt and amount of payment to the effect of such uncertainties as conditions precedent.[6] On the other hand, if this Court agrees that respondent's liability is established at year-end by state regulation, but decides that the uncertainties in issue do prevent satisfaction of the all events test, then it should address in its decision the specific uncertainty or combination of uncertainties it considers to prevent accrual.

VI. RESPONDENT'S METHOD OF ACCOUNTING CLEARLY REFLECTS ITS INCOME

Respondent's method of accounting accurately matches income to expenses and clearly reflects its income. By reporting an expense liability, which satisfies the all events test, in the same year as the income related to that expense, "the accounting method used by taxpayer results in allocation of the expense to the year in which the revenues were earned" (760 F.2d at 1293). If respondent is not permitted to accrue its year-end liability for guaranteed jackpots, its income will not be accurately reflected. For example, if a progressive slot machine is placed in service in July of one year and the jackpot on that machine is won in January of the next year, a

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[6] The government does not contend that conditions subsequent prevent accrual under the all events test. *See supra* note 5.

casino not allowed to accrue its liability would report most of the income related to the jackpot in the first year and all of the expense related to the jackpot in the second year. Such a method of accounting "would distort taxable income" (*id*).

The cases relied upon by the government to support its argument that the Commissioner has broad powers to determine whether a method of accounting clearly reflects income are off point. In those cases, taxpayers have attempted to avoid the application of established principles of tax accounting through use of estimates of future liability. For example, in *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961), this Court rejected a taxpayer's attempt to defer recognition of prepaid membership dues, which ordinarily would constitute income upon receipt,[7] based upon the taxpayer's estimates of when it would render the paid-for services. *Accord, e.g., Schlude v. Commissioner*, 372 U.S. 128 (1963); *Commissioner v. Hansen*, 360 U.S. 446 (1959); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957). In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the taxpayer attempted to write down excess inventory, in a manner "plainly inconsistent" with the applicable Treasury regulations, based not upon "objective evidence" but upon estimates and forecasts prepared by its management (*id.* at 533-35). This Court noted that "Thor's management simply wrote down its closing inventory on the basis of a well-educated guess that some of it would never be sold" (*id.* at 536), and stated that "Thor, in other words, sought a current 'deduction' for an estimated future loss" (*id.* at 542).[8] *Accord, e.g.,*

[7] *See North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

[8] *Thor Power Tool* was decided "in the light of the well-known potential for tax avoidance that is inherent in inventory accounting." (439 U.S. at 538.) Thus, that case should be considered in the context of its holding that the Commissioner has broad discretion in the area of inventory accounting.

Brown v. Helvering, 291 U.S. 193 (1934); *Lucas v. American Code Co.*, 280 U.S. 445 (1930).

To the contrary, in the instant case respondent reports its liability in accordance with the proper application of established tax accounting principles; namely, the all events test. Under that test, respondent's liability is established at year end by the Nevada Gaming Commission regulation, and the amount of that liability is determinable with reasonable accuracy. Respondent is not attempting to deduct an amount equal to an estimated future jackpot, but rather only the guaranteed jackpot amount.[9]

Finally, petitioner's reliance on unsupported speculation regarding the potential for tax avoidance is misplaced. The record in this case contains no evidence of untoward manipulation. As the Claims Court stated below, "this court will not hesitate to uphold the Commissioner's efforts to eradicate fraudulent practices, but, where no such practice has been alleged or proven and where the court has found that the timing of the deduction does not distort income, the court will not act on mere speculation" (5 Cl. Ct. at 646). Indeed, the government itself (Br. at 32) has acknowledged that the Commissioner has other weapons in its arsenal to deal with such manipulation were it to arise in the future.

VII. RESPONDENT'S POSITION IS CONSISTENT WITH THE DEFICIT REDUCTION ACT OF 1984

For taxable years subsequent to those involved in this proceeding, Congress has amended the Internal Revenue Code to provide that the all events test is not satisfied

[9] Based upon its own or the industry's experience, respondent may well be able to predict the average amount of guaranteed jackpots when won. However, in this proceeding respondent claims only the precise amount accrued on its progressive slot machines at year end.

until "economic performance" with respect to a liability has occurred. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601; I.R.C. § 461(h)(1). However, this economic performance standard is subject to an exception for certain "recurring items" the accrual of which "results in a more proper match against income." I.R.C. § 461(h)(3)(A)(iv)(II). For purposes of determining whether accrual results in a more proper match against income, "generally accepted accounting principles will be an important factor," and certain evenly accruing expenses (such as insurance or rent expenses) "generally can be allocated to a period and are best matched to that period." Staff of the Jt. Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 264 (Jt. Comm. Print 1984).

In enacting these new provisions, Congress was principally concerned that accrual of deductions under the all events test fails to take into account the "time value of money" (*id.* at 260). Congress was not concerned that courts have misapplied the all events test in too liberal a fashion and expressly recognized that "[a] deduction for contingent liability generally is not allowed under present or prior law" (*id.* at 259). Indeed, in the "recurring item" exception to the "economic performance" requirement, Congress retained much of present and prior all events test law. This is further indication that the broad arguments advanced here by the government are inconsistent with accepted all events test principles.

Moreover, by imposing a new "economic performance" requirement, and by creating a "recurring item" exception, Congress has enacted a statutory scheme that enhances the Commissioner's ability to prevent the type of manipulation and potential for tax avoidance about which the government speculates in its brief. Given the enactment of the "economic performance" test in the

Deficit Reduction Act of 1984, there is no reason for this Court to accept petitioner's invitation to overturn established tax accounting principles in an attempt to prevent other taxpayers from attempting to do what the Internal Revenue Code has already been amended to prevent.

CONCLUSION

The judgment of the United States Court of Appeals for the Federal Circuit should be affirmed.

Respectfully submitted,

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